Johnson Stokes & Master

Private Equity Update

JSM's private equity newsletter

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China's new Anti-Monopoly Law

Highlights

China's new Anti-Monopoly Law (the **"New Law"**) which will commence on 1 August 2008 is of particular relevance to private equity investors because :

1. It affects timing for effecting transactions :
- if a transaction (whether it is onshore or offshore) meets the reporting threshold, notification is required, and the transaction has to be approved before it can take place;
- if the transaction creates competitive concerns, investigation may last up to 180 days;
- if the transaction could affect 'national security', a national security review has to be carried out;

2. It prohibits certain 'M&A' activity and other transactions that eliminate or restrict competition in a market in China (or are deemed likely to do so);

3. It prohibits certain trading practices that currently are quite common in China :
- entering into agreements with competitors to fix prices, limit production or sales volumes, share markets, restrict technology or development, or boycott competitors or customers;
- entering into agreements with trading partners to fix resale prices or restrict minimum resale prices to third parties;
- abuse of a 'dominant market position' by selling products at unfairly high prices and (where it cannot be justified) the act of selling below cost, refusing to trade with partners, or imposing unreasonable trading conditions or 'tie-in' to sales.

On 30 August 2007, China introduced a New Law, which is scheduled to commence on 1 August 2008.

The New Law is China's first comprehensive competition law. It is of particular importance to private equity investors, as it may impact on their investment activities moving forward, as well as the activities of companies operating in China in which they hold an interest. It contains prohibitions and reporting requirements relating to mergers and acquisitions and other investment activity with a relevant nexus to China. The New Law also prohibits a range of anti-competitive conduct in markets in China.

In this update we provide a brief overview of the New Law. We also highlight aspects of the New Law likely to be of significance to private equity investors.

1. Background: China's existing 'competition law' regime

China has existing laws containing anti-monopoly provisions and anti-competitive conduct prohibitions.

However, these laws are of limited scope and have not been rigorously enforced. Accordingly, they have had little impact on the activities of most private equity investors.

Existing 'merger control' prohibitions and reporting requirements

The Regulations on the Acquisition of Domestic Enterprises by Foreign Investors (**"M&A Regulations"**) prohibit merger and acquisition activities that cause "excessive concentration" or "impede fair competition" in a market in China. The M&A Regulations also require reports to be filed with Chinese government bodies in relation to certain transactions relating to Chinese companies and relevant ‘offshore‘ transactions. Whether or not a transaction needs to be reported depends on whether a party to the transaction (or ‘affiliates‘ of foreign parties, in some cases) meets stipulated thresholds relating to turnover, assets, or market presence in China.

As the relevant reporting thresholds are relatively low, many transactions undertaken by private equity investors will easily trigger a reporting requirement. As an example, reporting is required for any merger or acquisition transaction by a foreign company, if the China turnover of the foreign company and its affiliates exceeds RMB $1.5bn in one year. This applies regardless of whether the target is a Chinese company or operates in Chinese markets.

However, it appears that no follow-up activity or investigation is taken in relation to the vast majority of transactions that are reported under the M&A Regulations. Further, the M&A Regulations do not specify any consequences or penalties that may be imposed where the relevant prohibitions or reporting requirements are breached.

Existing anti-competitive conduct prohibitions
It has also been rare for anti-competitive conduct to be penalised in China. This is notwithstanding the existence of a number of laws containing relevant prohibitions, such as the Anti-Unfair Competition Law and the Price Law.

The absence of a single comprehensive competition law has resulted in a lack of cohesion in the enforcement of competition-related provisions. Additionally, the scope of activity that is regulated is narrower than in most developed economies. Accordingly, the portfolio companies of private equity investors rarely face significant issues relating to competition laws in China.

Significance of the New Law
When the New Law takes effect, it has the potential to significantly change the 'competition law' landscape that private equity investors will encounter in China. In particular, the New Law will broaden the scope for anti-monopoly review and reporting requirements in relation to business acquisitions in, or having a relevant nexus with, China. The New Law will also provide a framework for more consistent and rigorous regulatory action regarding anti-competitive conduct.

Sections 2 to 4 of this update contain a summary of the key prohibitions applying under the New Law.

2. Prohibitions and reporting requirements for relevant 'M&A' activity

Prohibited 'concentrations'
With effect from 1 August 2008, the New Law prohibits participation in a 'concentration' that has the effect or likely effect of eliminating or restricting competition. In this context, a 'concentration' refers to transactions involving:

- merger activity;
- the acquisition of 'control' over other companies through the purchase of shares or assets; or
- the acquisition of 'control' or the capability of imposing 'determinative effects' on other companies by virtue of contractual rights or other means.

The concepts of 'control' and 'determinative effects', as used in relation to this prohibition, are not defined.

Reporting requirements
The reporting requirement in the New Law applies not only to acquisitions of domestic companies by foreign investors, but also to acquisitions by domestic companies. In contrast to the M&A Regulations, foreign investors cannot avoid the reporting obligations under the New Law by using a wholly-owned foreign enterprise in China as a vehicle for acquiring an equity interest in a Chinese company.

Reporting thresholds
The New Law contemplates that there will be thresholds for reporting relevant transaction activity to the relevant Anti-Monopoly Law enforcement authority. However these thresholds have not yet been specified. It is expected they will be included in subsequent implementation rules or guidelines. If the applicable thresholds are met, reporting is mandatory, and the transaction will need to be approved before the relevant acquisition can take place.

An earlier draft of the New Law contained thresholds based solely on the turnover of the parties to the transaction. However, these thresholds were removed from the final version. Accordingly, it remains to be seen whether the applicable thresholds will reflect some or all of the turnover, asset, and market presence thresholds applying under the M&A Regulations. It is also unclear as to how the New Law will interact with the merger control provisions in the M&A Regulations. However, before the New Law takes effect on 1 August 2008 and its implementation rules setting out the requirements and procedures for making merger control filings are issued, the merger control provisions in the M&A Regulations will still be valid.

Intra-group transfer exemption

The New Law allows for an exemption to the reporting requirement to be granted for relevant intra-group transfers. No such form of exemption applies under the M&A Regulations.

It should be noted, however, that the exemption only applies where one party (whether or not involved in the relevant transaction) owns more than 50% of the shares or assets with voting rights of all the parties to the transaction.

Accordingly, the exemption will not always be available in relation to transactions between companies which are part of the investment portfolio of a private equity fund. For example, the exemption will not apply where the private equity investor has limited voting rights in relation to the transaction parties. Further, the exemption will also not apply where the only link between the transaction parties is that they are under the management of a group of common principals.

Investigation of reported transactions

The New Law provides some detail in relation to the procedures and timelines for review of reported transactions. If the transaction does not cause any competitive concern, the reported transaction may be approved or deemed to be approved within 30 days after all the relevant documents and information are submitted. However, if further investigation is necessary, review may last up to a maximum of 180 days.

National security review

Another significant element of the New Law is the requirement for government review before foreign companies are permitted to engage in investments or acquisitions which 'could affect national security'. No definition of the term 'national security' is provided in the New Law, and it is not clear what form the required review may take.

It is noted that the M&A Regulations contain a similar (but perhaps broader) review requirement in relation to proposed acquisitions by foreign companies which may affect 'national economic security'. The M&A Regulations also require that review occur before foreign investors are permitted to engage in acquisitions that relate to an 'important industry' in the Chinese economy, or that may transfer the controlling power of a Chinese company which holds a famous trademark or 'time-honoured' Chinese brand.

3. Prohibited 'monopoly agreements' & abuse of dominance

Private equity investors need to be aware that the New Law will prohibit many trading practices that have previously been common in China. As significant penalties and remedies may be imposed in the event of an infringement, investors will need to consider how these prohibitions may impact on the activities of their portfolio companies operating in China.

Of particular relevance are the provisions prohibiting companies from entering into 'monopoly agreements' or abusing a 'dominant market position'.

Monopoly agreements

'Monopoly agreements' are divided into horizontal monopoly agreements and vertical monopoly agreements.

'Horizontal' monopoly agreements include agreements between competitors to:

- fix prices;
- limit production or sales volumes;
- share markets;
- restrict technology purchases or development; or
- boycott competitors or customers.

'Vertical' monopoly agreements include agreements between a company and its trading partners to:

- fix resale prices; or
- restrict minimum resale prices to third parties.

Exceptions

These monopoly agreements are deemed to unlawfully restrict competition unless any of the exceptions set out in the New Law apply. The exceptions include agreements that can:

- improve technology;
- raise quality of product and production efficiency;
- enhance the competitiveness of small or medium-sized companies;
- release the pressure of serious decreases in sales or distinct over-supply during economic downturns;
- ensure legitimate interests are protected in relation to foreign trade and economic cooperation; or
- achieve "social public interests".

The concept of 'social public interests" is not defined, but examples like 'energy saving' and 'environmental protection' are provided.

Abuse of a dominant market position

Abuse of a 'dominant market position' is defined to include the sale of products at "unfairly high prices" and (where it cannot be justified) the act of selling below cost, refusing to trade with partners, or imposing unreasonable trading conditions or 'tie-ins' to sales.

The New Law denotes that a company has a 'dominant market position' where it is able to control the price or quantity of products or other trading conditions or to engage in conduct restricting or affecting entry of other companies into a relevant market.

When an assessment on 'dominance' is made, several factors have to be taken into account, which include a company's:

- market share and competitive situation of the relevant market;
- power to control sales and supply markets;
- financial power and technical conditions;
- other entities' reliance on such company on doing transactions; and
- the ease of entry into the relevant market.

Therefore, private equity investors have to watch-out for their market position, in particular if they have interests in more than one competitor, or vertically related companies, in a particular industry in China.

4. Prohibited abuse of administrative powers

The New Law also prohibits government departments and authorised organisations from abusing their administrative powers to curb competition. Examples provided include conduct that hinders the free movement of commodities among regions, and imposing discriminating requirements on products from other regions.

5. Enforcement, penalties and remedies

According to the New Law, the State Council will set up the Anti-Monopoly Commission to organise, harmonise and lead the anti-monopoly work. The New Law also provides for the State Council to entrust enforcement powers in relation to the New Law to certain authorities ("**Enforcement Authorit**y"), which are likely to include the Ministry of Commerce and the State Administration of Industry and Commerce.

In relation to monopoly agreements or the abuse of a dominant market position, the Enforcement Authority has the power to make 'cease and desist' orders, and to confiscate illegal gains and impose fines up to a percentage below 10% of total relevant turnover in the preceding year (or, where a monopoly agreement has not been implemented, to impose a fine up to an amount below RMB500,000). In relation to 'concentrations' in violation of the New Law, the Enforcement Authority can order the concerned parties not to proceed with the transaction, or to unwind it. It can also impose a fine up to an amount below RMB 500,000.

The New Law allows for leniency to be exercised where companies 'own up' to participation in prohibited conduct and cooperate in investigations. The New Law also contemplates that parties who suffer loss as a result of monopolistic conduct of others can institute a civil action for recovery.

6. The lead up to 1 August 2008

In the lead up to 1 August 2008, it is anticipated that guidelines and implementation rules will be issued by the State Council providing more detail in relation to certain provisions in the New Law and regulating the relationship between the New Law and other laws in China containing competition provisions.

It should be noted that the concepts behind the New Law are quite complex. A body of sophisticated legal interpretation has developed internationally in relation to concepts such as market-definition and "market dominance", and it will be interesting to see how these concepts are interpreted in the context of China.

For now, what can be said with certainty is that there is a growing focus on competition issues in China. Additionally, as we have seen in relation to enforcement of intellectual property rights, it appears that Chinese lawmakers are increasingly determined to ensure China's international obligations - which include providing for an environment of fair competition - are enforced. This suggests that going forward the New Law (and perhaps the pre-existing competition legislation) may be enforced with more vigour than has historically been the case for China's competition legislation.

Private equity investors will need to carefully consider the impact of these developments on their investment activities. In particular, they will need to consider how the New Law will affect future international and China-related investments. In addition, they will need to consider whether the existing business practices of their current portfolio companies in China will be impacted.